

# **EO Determinations CPE-GOVERNANCE**

## **May 2009**

### **What is Governance?**

Governance is the exercise of authority and control over an organization.

### **Why are we here? What do we hope to accomplish?**

- Provide context within which nonprofit governance has become an area of focus by IRS and others
- Describe ongoing discussion over the roles of the IRS, the states, and the sector in NP governance
- Explain how IRS LifeCycle governance document fits into this discussion
- Discuss your role in determinations
- Describe current IRS tools and other resources available
- Describe our next steps

### **This session is NOT;**

- A course on nonprofit governance under state law
- An answer to all questions you might have about nonprofit governance
- A simple checklist of dos and don'ts
- The end of the governance discussion

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

#### **What are the most important “take aways”?**

When it comes to nonprofit governance, one size does not fit all.

- Governance issues vary depending upon type, size, structure, and culture of the organization

It is our responsibility to administer the tax laws uniformly and fairly.

- Everyone in EO must understand why we are focusing on governance, what we mean when we say we will emphasize governance, and how we intend to do that across all of EO
  - Determinations, education and outreach, rulings and agreements, examinations

Our job is to assess whether an organization has complied with tax laws

- In some cases, this means looking at whether particular organization managers participated in decisions that resulted in excess benefits or other noncompliance (e.g., 4958 or PF excise taxes)
- In other cases, it means looking at whether the organization took certain steps to assure the fairness of the arrangement to the exempt organization (e.g., taken steps to establish reasonableness of compensation)
- It is not our job to determine the organization's governance structure, policies or practices, or to make decisions for them

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

#### **Background – Specific Actions by Sector**

- Panel on the Nonprofit Sector convened in 2004 to consider proposals to improve effectiveness and accountability of NP orgs., with particular attention to self-governance
  - Issued reports in 2005, 2006 and 2007
- Council on Foundations issued stewardship principles for private foundations in 2005
- American Law Institute project begun in 2000 to develop Principles of the Law of Nonprofit Organizations – draft issued in 2007
- ABA Coordinating Committee on Nonprofit Governance issued its Guide to Nonprofit Corporate Governance in the Wake of Sarbanes Oxley in 2005
- Numerous governance education programs held for organization board members and officers, practitioners, policy makers
- Accrediting organizations that set and assess standards before giving stamp of approval
  - Organizations that rate charities based on standards for accountability or on public data or input
- Research, academic and public interest groups and centers who study governance and promote good governance principles and practices

# **EO Determinations CPE-GOVERNANCE**

## **May 2009**

### **States' Role in Governance**

- Oversight by charity officials
  - Enforcement of state nonprofit corporation or trust statutes
  - Charitable trust principles
  - Charitable solicitation and fundraising registration and reporting
  - NASCO – National Association of State Charity Officials
- Audited financial statement requirements
- Examples of state statutes
  - Revised Model Nonprofit Corporation Act
  - California's Nonprofit Integrity Act of 2004, including governance provisions for charities

### **Examples of Relevant State Law**

- Who governs the organization – members or directors, trustees, and allocation of duties across them
- Who are the required officers of a corporation
- Business judgment rule and the decisions made by a governing body
- Duty of loyalty to the organization and duty of care
- Certain procedures and policies, including amendments to governing instruments
- Requirements regarding certain minimum or maximum board sizes or qualifications of directors
- Requirements regarding term limits for board members

# **EO Determinations CPE-GOVERNANCE**

## **May 2009**

### **Congress and Governance: Sarbanes-Oxley**

- Legislation responding to governance deficiencies in for profit world in last decade
- Generally not applicable to nonprofits, but does have limited application
- Imposes criminal liability on tax exempt and other organizations for:
  - Retaliation against whistleblowers that report federal offenses
  - Destruction of records with the intent to obstruct a federal investigation

### **Recent IRS History**

- In early 2007 EO posted Preliminary Staff Discussion Draft on good governance practices
- Put together a draft governance section for the 990 which we released in June 2007
- Over course of second half of 2007, finalized 990 governance section – released in Dec. 2007
- Used that experience to design an educational tool on governance for charities – LifeCycle – which we released in Feb. 2008
- April 2008 - released Form 990 draft instructions, including for governance questions
- April 2008 – TEGE Commissioner delivered speeches at Georgetown nonprofit conference addressing governance
- June 2008 – ACT issued its report on IRS role in nonprofit governance
- December 2008 – released official form and instructions for 2008 tax years (2009 filing season)

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

- December 2008 - EO Implementing Guidelines released, including governance project

#### **Stakeholder Feedback**

- ACT Report (June 2008) – The Appropriate Role of the IRS with Respect to Tax Exempt Organization Good Governance Issues
  - ACT - Advisory Committee on Tax Exempt and Government Entities
  - Comprised of experts in TEGE who volunteer to serve for specific terms – issue public reports
- Concern that we don't uniformly apply requirements within EO to all exempt organizations
  - Determination letters – sometimes insist on conflicts policies, on an independent board, or specific board size
  - Exam - practices may vary in terms of what we might require or accept as a corrective action plan to avoid revocation or other penalties (noted in ACT report)

#### **ACT Report – Methodology**

- Interviewed IRS and Treasury officials, state charity officials, and experts in the field
- Reviewed extensive set of general and specialized written materials and publications on the topic
- Reviewed for profit corporate governance materials, including Sarbanes Oxley
- Presented report to IRS Commissioner in June 2008
- Acknowledged IRS's longstanding stake and legitimate interest in governance issues as they related to compliance with federal tax laws

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

- Expressed concern IRS could drive behavior merely by asking about specific practices, causing organizations to adopt practices not suited to them

#### **ACT Report – Conclusions and Observations**

- IRS should continue to work with EO community
- Specific governance practices should be mandated only in rare circumstances
- Closer the nexus to tax compliance, the more appropriate the inquiry
- IRS should explain the specific relationship between tax compliance and each practice it is addressing
- Compliance Qs more appropriate than governance Qs or commentary
- Governance inquiries should be made in as neutral a manner as possible
- Qs about practices and approaches are typically better than Qs about policies
- IRS should expressly acknowledge when practices are not required
- IRS should expressly acknowledge that practices may be more appropriate for some organizations than for others, and that it respects the role of the governing body in making decisions
- Taking into account the absence of certain practices in determining whether to examine an organization may be appropriate in certain circumstances
- Consistency and fair treatment by IRS are critical
- Education, implemented thoughtfully, is more appropriate than pressuring change

#### **Nonprofit Governance Studies**

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

- Study of nonprofit governance practices and policies is increasing
- Too soon to tell whether there are trends or patterns, but these studies should help inform us and others about what is going on in the sector
- Two in particular we mention today to give you a flavor of what is being studied
  - 2005-2007 by Urban Institute
  - 2007 by BoardSource®

#### **2005-2007 Urban Institute Center on Nonprofits and Philanthropy Study**

- Survey of over 5,100 nonprofits
  - Stratified random sample, self reported data
  - Covered 2005
  - UI described it as first-ever national representative study of nonprofit governance
- 70% have trouble recruiting board members (p.16)
- Having CEO serve on board results in less engaged board and may undermine stewardship role of the board (p.22)
- Large board size doesn't necessarily weaken board performance or detract from board engagement (p.17)
- Smaller nonprofits that engage in financial transactions need to have more formal policies in place (pp. 10 and 22)
- Larger organizations need to have other board members frequently review transactions (pp. 10 and 22)
- Best practice guidelines or adopting new policies will not be sufficient to strengthen board performance and accountability (p.23)
- 67% of nonprofits have audits (p.4)
- Half of nonprofits have a conflict of interest policy, 29% required disclosure of financial interests (p.9)
- Less than 1% of nonprofits made loans to board members (p.4), but many buy/rent goods or services from board members, which more often than not does not yield savings in the way of below market rates (p.22)
- 2% compensate board members (p.11)

## **EO Determinations CPE-GOVERNANCE May 2009**

- 75% of organizations did not require board members to disclose financial interests in entities doing business with the nonprofit (p.8)

### **Nonprofit Governance Index 2007, BoardSource® (2007)**

- June 2007 survey of 2,152 nonprofit leaders on board composition, structures, oversight and performance
  - 1,126 chief executives; 1,026 board members
  - Not a statistical sample
- 37% under \$1M budget size; 37% \$1M to \$5M; 26% \$5M or over
- 80% public charities, 9% private foundations
- 99% of NPs have a written mission statement (p.5)
- 92% of NPs have an external financial audit (p.17)
  - 54% of NPs have an audit committee (p.17)
- Board size averages 16 voting members (p.10)
- 14% of chief executives are voting members of their boards; 4% are also board chair (p.10)
- Boards meet an average of 7 times a year (p.14)
- Boards meet an average of 16.5 hours a year (p.14)
- *Fundraising (p.6):*
  - 68% of charities require board members to contribute
  - 61% require them to identify donors for fundraising
- 3% of NPs pay board members a fee or honorarium, 29% reimburse for travel and meeting expenses (p.12)
- 67% of full boards approve chief executive's total compensation package, 65% consider salary at comparable organizations (p.18)

## **EO Determinations CPE-GOVERNANCE May 2009**

- 88% have a conflict of interest policy (p.16)

### **Today's Focus is Public Charities**

- Governance structures vary based on size, type, structure, and culture of organization – one size does not fit all
- Not all 501(c)(3)s are alike
  - Public charities versus private foundations
- Member organizations such as trade associations and social clubs have special considerations
  - They are accountable to members as well as to the public
- Cannot apply what you hear or learn today equally to all types of exempt organizations
- Good governance is important to safeguarding assets and operating to further exempt purposes

### **Background – Governance Life Cycle for Charities**

- The LifeCycle governance document is an educational tool aimed at helping organizations and their governing bodies consider certain governance practices and policies during both the formation and operation of the organization
  - Not recommended practices but encourage certain items
  - Generally applies to public charities
- Advises organizations what they will be required to report about on new 990
- Six topic areas – mission, organizational documents, governing body, policies, financial statements and 990 reporting, transparency, and accountability

# **EO Determinations CPE-GOVERNANCE**

## **May 2009**

### **What is Governance?**

Governance is the exercise of authority and control over an organization.

Remember, One Size Does Not Fit All! Governance issues vary depending upon type, size, structure, and culture of the organization (fact and circumstances).

### **What is a Governing Body?**

Per the IRS Form 990 Instructions, the Governing Body is “the group of persons authorized under state law to make governance decisions on behalf of the organization and its shareholders or members, if applicable. The governing body is, generally speaking, the board of directors (sometimes referred to as board of trustees) of a corporation or association, or the board of trustees of a trust”.

### **The General Purposes of a Governing Body are:**

- 1) Stewardship-the governing body manages the charity on behalf of the general public. This is their principal role.
- 2) Mission Focus-resources and efforts must remain focused on the charities mission.
- 3) Oversight-the governing body is responsible for reviewing and approving items such as the organization’s mission, annual budget, key financial transactions and compensation.
- 4) Fulfillment of Obligations-the governing body is ultimately responsible for ensuring that a charitable organization fulfills its obligations to the law, donors, employees and the public.

## EO Determinations CPE-GOVERNANCE

### May 2009

- 5) Asset Protection-the governing body must protect the organization's assets and ensure their charitable use.
- 6) Vision and Strategic Direction-the governing body sets the vision and mission for the organization and establishes policies and strategic direction to fulfill charitable purposes.
- 7) Hiring a Chief Executive Officer-the governing body is not expected to manage day-to-day activity. The governing body appoints officers, such as the Chief Executive Officer, and oversees their work to ensure charitable purposes are served.

### IRS Areas of Interest

#### Active and engaged

The Internal Revenue Service encourages an **active and engaged** board and believes that it is important to the success of a public charity and to its compliance with applicable tax law requirements. Governing boards should be composed of persons who are informed and active in overseeing a charity's operations and finances. If the governing board tolerates a climate of secrecy or neglect, there is concern that charitable assets are more likely to be diverted to benefit the private interests of insiders at the expense of the public and charitable interests. Successful governing boards include individuals who are not only knowledgeable and engaged, but selected with the organization's needs in mind (e.g., accounting, finance, compensation and ethics).

#### Appropriately sized

Attention should also be paid to the **size of the board** ensuring that it is the appropriate size to effectively make sure that the organization obeys tax laws, safeguards its charitable assets, and furthers its charitable purposes. Very small or very large governing boards may not adequately serve the needs of the organization. Small boards run the risk of not representing a sufficiently broad public interest and of lacking the required skills and other resources required to effectively govern the organization. On the other hand, very large boards may have a more difficult time getting down to business and making decisions. If an organization's governing board is large, the organization may want to establish an executive committee with delegated responsibilities or advisory committees.

#### Composed of primarily independent members

Irrespective of size, a governing board should include **independent members** and should not be dominated by employees or others who are not, by their very

## EO Determinations CPE-GOVERNANCE

### May 2009

nature, independent individuals because of family or business relationships. The Internal Revenue Service reviews the board composition of charities to determine whether the board represents a broad public interest, and to identify the potential for insider transactions that could result in misuse of charitable assets. The Internal Revenue Service also reviews whether an organization has independent members, stockholders, or other persons with the authority to elect members of the board or approve or reject board decisions, and whether the organization has delegated control or key management authority to a management company or other persons.

#### IRS Areas of Interest (continued)

##### Structure: who is governing the organization?

The directors or trustees, provided they have voting rights, are members of the governing body, who are in charge and **govern** the organization's affairs. Members of advisory boards that do not have voting rights (thus do not exercise any governing authority over the organization) are not considered directors or trustees.

One of the most important functions of the board is keeping the resources and efforts focused on the charity's mission. This requires the board to have an adequate understanding of the organization's programs, people, and resources available to achieve the organization's goals. Successful governing boards include individuals who are not only knowledgeable and engaged, but selected with the organization's needs in mind (e.g., accounting, finance, compensation and ethics).

##### Are the meetings documented?

The Service encourages the organization to take steps to ensure that every meeting held and written actions taken by its governing body and committees with authority to act on behalf of the governing body are **documented**.

##### Policies and practices

The Internal Revenue Code does not require charities to have governance and management policies; however, the Service reviews an organization's application for exemption and annual information returns to determine whether the organization has **implemented policies** relating to conflicts of interest,

## **EO Determinations CPE-GOVERNANCE May 2009**

whistleblower claims, document retention and destruction policies, compensation, and investments.

**Warning-these are areas of interest, NOT requirements for exemption**

### **Form 1023 Part V**

Part V of the Form 1023 details the compensation and other financial arrangements with the applicant's Officers, Directors, Trustees, Employees and Independent Contractors. Part V consists of 9 questions and is located on pages 2 thru 5 of the Form 1023.

Question 1 consists of 1a, 1b and 1c. It requests the names, titles, mailing addresses and compensation of the applicant's officers, directors, and trustees, 5 highest compensated employees who receive more than \$50,000 per year and 5 highest compensated independent contractors who receive more than \$50,000 per year.

Question 2 consists of 2a, 2b and 2c. It requests information about any family or business relationships between the applicant's officers, directors, or trustees. It also asks about business relationships with the applicant's officers, directors, or trustees that are not related to their position as an officer, director, or trustee and if any of the applicant's officers, directors, or trustees is related to any of the employees or independent contractors listed in 1b and 1c.

Question 3 consists of 3a and 3b. It requests a list, containing all of the persons listed in 1a, 1b and 1c, showing their name, qualifications, average hours worked, and duties and if any of the persons listed in 1a, 1b and 1c receive compensation from any other organization that is related to the applicant through common control.

Question 4 consists of 4a, 4b, 4c, 4d, 4e, 4f and 4g. Question 4 asks if in establishing compensation levels certain recommended practices were used. The practices include following a conflict of interest policy, advanced approval, written documentation of the date, terms, and decision of each individual who

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

voted, and basing decisions on documented compensation paid by similar organizations, independent surveys, or actual written offers. If the applicant answered “no” to any of recommended practices, a description is requested as to why the compensation is reasonable.

Question 5 consists of 5a, 5b and 5c. It asks if the applicant has adopted a conflict of interest policy, procedures regarding conflicts of interest and compensation and procedures regarding conflicts of interest and business deals.

Question 6 consists of 6a and 6b. It asks if any of the persons listed in 1a, 1b and 1c receive compensation through non-fixed payments and if any of the applicant’s employees not listed in 1a, 1b or 1c receive compensation through non-fixed payments.

#### **Form 1023 Part V (continued)**

Question 7 consists of 7a and 7b. It asks if the applicant will purchase any goods, services, or assets from any person listed in 1a, 1b or 1c or sell any goods, services, or assets to any person listed in 1a, 1b or 1c.

Question 8 consists of 8a, 8b, 8c, 8d, 8e and 8f. It asks if the applicant has any leases, contracts, loans, or other arrangements with any person listed in 1a, 1b or 1c. It also asks about written or oral arrangements, whom the arrangements are with, arms-length negotiations and how the applicant determines fair market value. Finally, it requests copies of leases, contracts, loans and other agreements.

Question 9 consists of 9a, 9b, 9c, 9d, 9e and 9f. It asks about leases, contracts, loans or other agreements with any organization in which any person listed in 1a, 1b or 1c has more than a 35% interest. If the answer is “yes”, the applicant is asked for a description of any agreements, whom the arrangements are with, arms-length negotiations and how the applicant determines fair market value. Finally, it requests copies of leases, contracts, loans and other agreements.

# **EO Determinations CPE-GOVERNANCE**

## **May 2009**

### **Organizing Document**

The organizing document provides the framework for governance and management. The organizing document may be articles of incorporation, articles of organization, articles of association or constitution, or trust agreement.

The Service requires the submission of organizational documents with an application for exemption and will review the documents to ensure that the applicant is organized exclusively for exempt purposes.

### **Bylaws**

The bylaws are the rules governing the internal affairs of an organization.

A governing board's activities are determined by the powers, duties, and responsibilities conferred on it by an authority outside itself. These matters are typically detailed in the organization's bylaws. The bylaws commonly specify the number of members of the board, how they are to be chosen, and when they are to meet.

The Service requires the submission of bylaws, if adopted, with an application for exemption and will review the document to ensure that the applicant activities are consistent with guidelines in the bylaws.

# **EO Determinations CPE-GOVERNANCE**

## **May 2009**

### **Governing Body Items**

#### **Size of the Governing Body**

The ideal size of a board depends on many factors such as the age of the organization; the nature of the mission and activities; the geographic scope of mission and activities; as well as the funding needs. The Service recommends that every public charity should review its board size periodically to determine the most appropriate size to ensure effective governance and to meet the organization's goals and objectives.

#### **Term Limits of Board Members**

Term limits for board members are an effective way to ensure board vitality. If the board does not have term limits, the Service encourages the organization to review its board membership periodically to confirm that board members remain interested in and suitable for the board.

#### **Diversity of the Governing Body**

The nominating process should reach out for candidates, actively recruiting individuals whose commitment, skills, life experience, background, perspective, and other characteristics will serve the public charity and its needs. Areas of expertise that are beneficial to a board include: budget and financial management, investments, personnel, public relations and marketing, governance, advocacy, and leadership. Financial skills are among the most

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

important qualities found on a diverse board. It is not a mandate that every board membership must include all of these qualifications.

#### **Board Meetings**

Ideally, the board should meet regularly enough to conduct its business and fulfill its duties. Regular meetings provide the chief venue for board members to review the organization's financial situation and program activities; establish and monitor compliance with key organizational policies and procedures; and address any issues that affect the organization's ability to fulfill its charitable mission.

#### **Board Committees**

If the board has committees that are authorized to handle some work between board meetings, the governing documents should specify whether the board may create these committees. Board committees and task forces should be effectively designed to facilitate the work of the Board. Committee functions should follow the board's role of governance; they should not mirror staff responsibilities.

#### **Governing Body Items (continued)**

##### **Board Independence**

All directors of a nonprofit organization have a "duty of loyalty" that requires them to put interests of the organization above personal interests and to make decisions they believe are in the best interest of the nonprofit. The Service believes that it is very important to the long-term success and accountability of the organization that a sizable majority of the board members be free of financial conflicts of interest. The Service suggests (but does not enforce) that a majority of the board of a public charity should be independent, meaning they should

##### **NOT:**

- Be compensated by the organization as employees or independent contractors;
- Have their compensation determined by individuals who are compensated by the organization;
- Receive, directly or indirectly, material financial benefits from the organization except as a member of the charitable class served by the organization; and
- Be related to anyone described above

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

#### **Board Compensation**

Any compensation paid to board members must be reasonable and necessary to support the performance of the organization in its exempt function. When organizations find it appropriate to compensate board members, due to the nature, time or professional competencies involved in the work, they must be prepared to provide detailed documentation of the amount and reasons for such compensation, including the responsibilities of board members and the services they provide

#### **Management Policy Items**

##### **Executive Compensation**

Although the Internal Revenue Code does not require charities to follow a particular process in determining the amount of compensation to pay, the compensation of officers, directors, trustees, key employees, and others in a position to exercise substantial influence over the affairs of the charity should be reasonable and determined by persons who are knowledgeable in compensation matters and who have no financial interest in the determination.

##### **Conflicts of Interest**

A conflict of interest arises when a person in a position of authority over an organization, such as an officer, director, or manager, may benefit financially from a decision he or she could make in such capacity, including indirect benefits such as to family members or business association.

The Internal Revenue Service encourages a charity's board of directors to adopt and regularly evaluate a written conflict of interest policy that requires directors and staff to act solely in the interests of the charity without regard for personal interests; include written procedures for determining whether a relationship, financial interest, or business affiliation results in a conflict of interest; and

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

prescribes a course of action in the event a conflict of interest is identified. Instructions to Form 1023 contain a sample conflict of interest policy.

#### **Investments**

Increasingly, charities are investing in joint ventures, for-profit entities, and complicated and sophisticated financial products or investments that require financial and investment expertise and, in some cases, the advice of outside investment advisors. The Internal Revenue Service encourages charities that make such investments to adopt written policies and procedures requiring the charity to evaluate its participation in these investments and to take steps to safeguard the organization's assets and exempt status if they could be affected by the investment arrangement.

Organizations that file Form 1023 will find that Part VIII, item 8, asks whether they enter or will enter into joint ventures, including partnerships or limited liability companies treated as partnerships, in which they share profits and losses with partners other than section 501(c)(3) organizations, and, if so, they must describe the activities of these joint ventures in which they participate or will participate.

#### **Management Policy Items (continued)**

##### **Fundraising**

Charitable fundraising is an important source of financial support for many charities. Compensation for fundraising activities should reflect the skill, effort, and time expended by the individual or firm on behalf of the charity rather than based on a commission or a percentage of the amount raised. Charities are encouraged to keep their fundraising costs reasonable and to provide information about fundraising costs and practices to donors and the public.

##### **Governing Body Minutes and Records**

The Internal Revenue Service encourages the governing bodies and authorized sub-committees to take steps to ensure minutes of meetings, strings of emails, or similar writings that explain actions taken are contemporaneously documented. Per instructions for Form 990, Part VI, Section A, Line 8, contemporaneous means by the later of (1) the next meeting of the governing body or committee (such as approving the minutes of the prior meeting), or (2) 60 days after the date of the meeting or written action

##### **Document Retention and Destruction**

## EO Determinations CPE-GOVERNANCE

### May 2009

A written document-retention policy, consistently monitored over time, is essential for protecting the organization's records of its governance and administration, as well as business records that are required to demonstrate legal compliance. Such a policy helps to protect against allegations of wrongdoing by the organization or its directors and managers.

For more information, see IRS Publication 4221-PC, ***Compliance Guide for 501(c)(3) Public Charities***, available on the IRS website. Charities are required by the Internal Revenue Code to keep books and records that are relevant to its tax exemption and its filings with the Internal Revenue Service.

#### Ethics and Whistleblower Policies

The public expects a charity to abide by ethical standards that promote the public good. The governing body bears the ultimate responsibility for setting ethical standards and ensuring they permeate the charity and its practices. The Service encourages, but does not require, that every charity have clear policies and procedures that allow staff, volunteers, or clients of the charity to report suspected wrongdoing within the charity without fear of retribution. Such policies can help the board and senior managers become aware of and address problems before serious harm is done to the charity

#### Governance Related Citations

##### Regulations 1.170A-9 (f)(3)(v)

**Regs. 1.170A-9 (f)(3)(v)**--Representative governing: The fact that an organization has a governing body which represents the broad interests of the public, rather than the personal or private interests of a limited number of donors (or persons standing in a relationship to such donors which is described in section 4946(a)(1)(C) through (G)) will be taken into account in determining whether an organization is 'publicly supported.' An organization will be treated as meeting this requirement if it has a governing body (whether designated in the organization's governing instrument or bylaws as a Board of Directors, Board of Trustees, etc.) which is comprised of public officials acting in their capacities as such; of individuals selected by public officials acting in their capacities as such; of persons having special knowledge or expertise in the particular field or discipline in which the organization is operating; of community leaders, such as elected or appointed officials, clergymen, educators, civic leaders, or other such persons representing a broad cross-section of the views and interests of the community; or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership

## **EO Determinations CPE-GOVERNANCE May 2009**

### Regulations 1.509(a)-3(d)(3)(i)

**Regs. 1.509(a)-3(d)(3)(i)**--the governing body is one of the pertinent factors to determine whether the organizational structure, programs or activities, and method of operation of an organization are such as to enable it to meet the tests under section 509(a)(2).

Whether the organization has or will have a governing body which is comprised of public officials, or individuals chosen by public officials acting in their capacity as such, of persons having special knowledge in the particular field or discipline in which the organization is operating, of community leaders, such as elected officials, clergymen, and educators, or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership. This characteristic does not exist if the membership of the organization's governing body is such as to indicate that it represents the personal or private interests of disqualified persons, rather than the interests of the community or the general public.

### **Governance Related Citations (continued)**

#### IRM 7.20.4.6

**IRM 7.20.4.6** addresses non-private foundation board expansion. It indicates that:

“Generally, expansion of an organization’s board is a possible method to lessen the degree of concern where the strong possibility for inurement or private benefit is suggested by an organization’s application for exemption.”

It further indicates that:

“We cannot require that an organization expand its board or adopt a conflict of interest policy as a condition of exemption. If an organization refuses to expand its board and inurement cannot be proven to have occurred but is likely, then a detailed explanation justifying exemption should be incorporated into Form 6038 when closing a case. Where there is strong potential for inurement, a referral should be made for a future year examination using Form 5666.”

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

#### Revenue Rulings

**Revenue Ruling 55-656**, 1955-2 C.B. 262, held that a nursing bureau was exempt under section 501(c)(3) of the Code since it was primarily controlled and supported by the general public for the public benefit.

**Revenue Ruling 61-170**, 1961-2 C.B. 112, held that a nursing bureau was not exempt under section 501(c)(3) of the Code since it was primarily engaged in the performance of personal services for its membership. Significant factors included that the bureau drew its support primarily from its membership and was controlled by a governing board composed of professional nurses, without public participation of any kind.

**Revenue Ruling 69-383**; 1969-2 C.B. 113, affirmed the exempt status of a hospital in light of a fixed percentage compensation package for the head of the hospital's radiology department. The ruling stated that the radiologist did not control the organization, the compensation agreement was negotiated at arms length and the compensation was reasonable. Therefore, the independence of the governing body was a factor in affirming exempt status.

**In Rev. Rul. 69-545**, 1969-2 C.B. 117, an independent board was one of the favorable factors that the Service took into consideration in ruling a hospital was exempt under IRC 501(c)(3). As stated in the ruling, "Furthermore, Hospital A is operated to serve a public rather than a private interest. Control of the hospital rests with its board of trustees, which is composed of independent civic leaders."

#### **Governance Related Citations (continued)**

#### Court Cases

There is nothing in the federal statutory law, the federal tax regulations, or IRS rulings that, as a general rule, dictate the composition of the board of directors, or other governing body, of a tax-exempt organization. Nonetheless, several court cases have considered the composition of the governing board as a factor in their decision.

In **Levy Family Tribe Found., Inc. v. Comm'r**, 69 T.C. 615, 619 (1978) the Tax Court found that all of the directors and officers of an organization were related and it could not find the "necessary delineation" between the organization and these persons acting in their personal and private capacity.

In **Merle E. Parker, the Foundation for Divine Meditation, Inc. v. Comm'r**, 365 F.2d 792, 799 (8<sup>th</sup> Cir. 1966), cert. den., 385 U.S. 1026 (1967) the court concluded that one individual who had "complete and unfettered control" over an organization had a special burden to explain certain withdrawals from the organization's bank account.

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

In **United Libertarian Fellowship, Inc. v. Comm'r**, 65 T.C.M. 2175, 2181 (1993) the U.S. Tax Court stated that “where the creators control the affairs of the organization, there is an obvious opportunity for abuse, which necessitates an open and candid disclosure of all facts bearing upon the organization, operation, and finances so that the Court can be assured that by granting the claimed exemption it is not sanctioning an abuse of the revenue laws”.

In **Wendy L. Parker Rehabilitation Foundation, Inc. v. Comm'r**, T.C. Memo 1986-348, the organization was found not to meet the requirements of section 501(c)(3) of the Code. The foundation was formed by the Parker family and benefits inured to Wendy Parker (who was related to all directors). While the family’s control over the organization did not in itself preclude exemption, it highlighted the inurement of earnings to the Parker family.

In **Western Catholic Church v. Comm'r**, 73 T.C. 196, 213 (1979) the court considered an organization with three directors (the founder, his wife, and their daughter) among a membership base of five. The small size of the organization was held to be “relevant,” with the court finding private inurement and private benefit because of the “amount of control” the founder exercised over the organization’s operations and the “blurring of the lines of demarcation between the activities and interests” of the organization. The court observed that “this is not to say that an organization of such small dimensions cannot qualify for tax-exempt status.” In **John Thomas Blake and Angelina Blake v. Comm'r**, 29 T.C.M. 513 (1970), an organization of similar dimensions as the one described in **Western Catholic Church** was ruled to be tax-exempt. It should be noted that private benefit and private inurement were not issues in the case.”

### **Miscellaneous Items**

#### **Private Foundations**

Technically, a private foundation is a charitable organization that is not a public charity. Due to its nature, it is typical for a private foundation to have a related board. The federal law governing the operations of private foundations is a composite of rules pertaining to self-dealing, mandatory payout requirements, business holdings, investment practices, various types of expenditures, and more. Due to these rules, the composition of a private foundation governing board is not a concern during the determination process.

### **IRS.GOV**

IRS.GOV is an excellent source of information regarding governance for both the specialist and the applicant.

## EO Determinations CPE-GOVERNANCE

### May 2009

An example is “*Governance of Charitable Organizations and Related Topics*”. This IRS.gov web page contains a link to “*Governance and Related Topics-501(c)(3) Organizations*” that provides information about important governance topics to be considered over the life of an exempt organization.

### **Form 990**

As revised for tax year 2008, the IRS Form 990, *Return of Organization Exempt From Income Tax*, the annual information return filed by many charities, requires reporting organizations to answer questions about governance, management, and disclosure. For examples, see Form 990, Part VI, *Governance, Management and Disclosure*, and Part XI, *Financial Statements and Reporting*.

### **Special Cases**

In a few situations, the IRS imposes rules concerning board composition.

The principle exception on this topic is a rule in the **facts and circumstances test**. This test looks to whether the organization has a governing body that represents the “broad interests of the public”, rather than the personal or private interests of a few individuals.

In the law concerning **supporting organizations** there are rules that mandate certain forms of overlapping board and limitations on the extent to which disqualified persons can control the organization.

IRS.gov summarizes the new rules involving **credit counseling** organizations. On January 6, 2009, the web site was updated to indicate, in part, that “a majority (at least 51%) of the board members must represent the broad interests of the public”.

## EO Determinations CPE-GOVERNANCE

### May 2009

The Service will not allow a **tax-exempt hospital's** board of directors to be dominated by the medical staff physicians.

The participation of a public charity in a limited **partnership** may be conditioned on the requirement that representatives of other partners are not on the board of the charitable organization.

Good governance is a positive factor when considering **unusual grants**

### **Possible Approaches to Problem Boards**

#### **Facts and Circumstances**

Generally, board expansion cannot be required and recommendations for expansion do not need to be made every time that related parties control the board. Facts and circumstances must be considered. For example, it is often difficult for new organizations to attract additional board members. Another consideration is that, in the case of small organizations with an unpaid volunteer board, the potential for private benefit is usually minimal. In addition, there are other methods to address issues, such as adoption of a conflict of interest policy or an audit referral. As always, it is essential that a specialist document their consideration of the facts and circumstances

## EO Determinations CPE-GOVERNANCE

### May 2009

#### Board Expansion

In some cases it may be appropriate to recommend that an organization expand the board to create a “community board”.

The before mentioned “facts and circumstances test” defines a community board as those composed of:

- 1) Community leaders, such as elected or appointed officials, members of the clergy, educators, civic leaders, or other such individuals representing a broad cross-section of the views and interests of the community,
- 2) Individuals having special knowledge or expertise in the particular field or discipline in which the organization is operating,
- 3) Public officials acting in their capacities as such,
- 4) Individuals selected by public officials acting in their capacities as such, and
- 5) In the case of a membership organization, individuals elected pursuant to the organization’s governing instrument or bylaws by a broadly based membership.

#### Conflict of Interest

In some cases the adoption of a conflict of interest policy can address our governance concerns.

A conflict of interest arises when a person in a position of authority over an organization, such as a director, officer, or manager, may benefit personally from a decision that he or she could make. A conflict of interest policy consists of a set of procedures to follow to avoid the possibility that those in positions of authority over an organization may receive an inappropriate benefit.

#### **Possible Approaches to Problem Boards (continued)**

#### Audit Referral or other possible follow-up

Generally, we cannot require that an organization expand its board nor adopt a conflict of interest statement as a condition of exemption. If an organization refuses to expand its board or adopt a conflict of interest policy and inurement is likely, but cannot be proven, then when closing the case a referral using the ROO referral form or Form 5666 should be considered.

#### Contributing Factor to an Adverse Position

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

Governance practices can be factors contributing to an adverse case. However, a “non-community” board cannot be the sole factor in an adverse case.

Typically, bad governance practices can be shown to highlight the control of an organization by individuals who are receiving an undue private benefit from the organization.

#### **Summary**

- Each organization needs to decide for itself how best to govern – one size does not fit all
- Not our role to tell them how to govern
- All of EO must understand our role in the area and what we are trying to accomplish in the areas of education and outreach, rulings and agreements, and examinations
- We will keep you posted and seek your input along the way

# **EO Determinations CPE-GOVERNANCE**

## **May 2009**

### **EO Next Steps**

Develop examination checksheet regarding various governance topics to explore link between good or bad governance and compliance with tax laws

Incorporate Form 990 questions and responses into compliance initiatives

Continue training - what further training or emphasis is needed?

### **Governance Project Objective**

Long term study by IRS – this is not something we will do quickly

Will include several segments along with different activities over the span of several years in order to accomplish the project objective.

- Compliance Checks
- Examinations

### **Where do you go if you have questions about nonprofit governance in general?**

Outside sources – not authoritative in legal sense but excellent discussions of issues

- ACT Report
- Independent Sector/Nonprofit Panel Reports

IRS sources

- IRS LifeCycle governance document
- Governance Project Team Members

## **EO Determinations CPE-GOVERNANCE**

### **May 2009**

#### **Governance Project Team Members**

|                                |                |
|--------------------------------|----------------|
| Russell Renwicks (Team Leader) | (410)-962-3404 |
| Geoffrey Campbell (R&A)        | (202)-283-8918 |
| Meghan Wrathall (R&A)          | (202)-283-8945 |
| Mitchell Steele (R&A)          | (513)-263-3677 |
| Kim Thoa T Nguyen (R&A)        | (513)-263-3423 |
| Eric Thomas (CSCI)             | (954)-423-7708 |
| Cheryl Teser (CSCI)            | (402)-233-7371 |
| Don Evans (Economist)          | (202)-283-0521 |